

Too-small-to-survive banks: an overview [interview]

Article (Unspecified)

Papanikolaou, Nikolaos (2013) Too-small-to-survive banks: an overview [interview]. Delano Magazine.

This version is available from Sussex Research Online: <http://sro.sussex.ac.uk/id/eprint/47387/>

This document is made available in accordance with publisher policies and may differ from the published version or from the version of record. If you wish to cite this item you are advised to consult the publisher's version. Please see the URL above for details on accessing the published version.

Copyright and reuse:

Sussex Research Online is a digital repository of the research output of the University.

Copyright and all moral rights to the version of the paper presented here belong to the individual author(s) and/or other copyright owners. To the extent reasonable and practicable, the material made available in SRO has been checked for eligibility before being made available.

Copies of full text items generally can be reproduced, displayed or performed and given to third parties in any format or medium for personal research or study, educational, or not-for-profit purposes without prior permission or charge, provided that the authors, title and full bibliographic details are credited, a hyperlink and/or URL is given for the original metadata page and the content is not changed in any way.

Finance

RISKY RESEARCH

Both theory and practice were dissected when the Grand Duchy played host to one of the world's largest international financial research summits in June. Delano caught up with three Luxembourg School of Finance professors to find out why holding the FMA European conference is such a big deal, and what insights are being brought to light by the ten-year old faculty. The three academics, it turns out, have some pretty surprising findings on risk that could potentially have big implications for euro zone politicians, investment fund managers, and small banks and their regulators.

Text by *Aaron Grunwald* Photography by *Olivier Minaire*

THORSTEN LEHNERT
Moodiness increases risk

As the Grand Duchy's financial centre has grown, so has its emphasis on developing a body of academia to support it. So it's a bit of a coup that the University of Luxembourg's ten year old Luxembourg School of Finance hosted the Financial Management Association International's annual European conference in mid-June.

The FMA is one of the world's largest groups for professors and students of finance and economics—primarily active in the US and with chapters in Australia, China, Egypt, Ireland, Mexico, New Zealand and the UK—and is publisher of the academic journals *Financial Management* and the *Journal of Applied Finance*.

This year's three-day confab—held at the Abbaye de Neumünster and supported by the European Investment Bank—brought “together academics and practitioners with interests in financial decision-making” and featured “presentations of research papers, panel discussions, plenary and keynote talks, and tutorials,” the university explains.

Professor Christian Wolff, director of the LSF, co-chaired the conference along with professor Theo Vermaelen of Paris-based INSEAD, which is consistently rated as one of the top 10 business schools in global rankings. Wolff is “*really very happy about*” having hosted the FMA, which he ranks in the top five worldwide in financial academia. “*For a school of finance as young as the LSF, this is really an excellent way to present ourselves, and bring hundreds of colleagues and practitioners to Luxembourg. Many people came here for the first time*” and in the end it will be “*very beneficial*” to the LSF's reputation. If nothing else, it will help the school with “*exposure*” with some of the leading academics that it wants to recruit, Wolff explains.

From an academic point of view, “*it would be exactly the same for me if I participated in the very same conference in Paris or London,*” says LSF professor Nikolaos Papanikolaou. Except it marks a “*great success*” for the university,

which after all is chartered with supporting Luxembourg's competitive financial centre.

Hosting the FMA is great for “*networking*” with peers, reckons LSF professor Thorsten Lehnert. In the academic world, “*publishing papers is important, but these types of events are also important*” in making a name for yourself. In recent years the summit has been held in Barcelona, Istanbul and larger European capitals, so hosting the summit goes a long way to helping put “*the LSF on the map*”.

While the conference is academically rigorous, the LSF was particularly keen on members of the Grand Duchy's financial and business communities being there, and even offered a “*special local rate*” to Luxembourg-based attendees.

Perhaps because many of the dozens of papers presented and panel topics discussed have practical, real world applications.



LUXEMBOURG SCHOOL OF FINANCE

Founded in 2003 and now part of the University of Luxembourg, the LSF says more than 250 students representing more than 30 nationalities have completed its master's in banking and finance programme. In October, the LSF will initiate a new master's programme in wealth management, in cooperation with the banking trade group ABBL, which will roughly double the school's size.

www.lsf.lu



Euro at risk

Wolff, for instance, talked about LSF research on how much risk each euro zone member state's sovereign debt adds to the common currency's overall riskiness. Starting about a year ago, he and four other LSF academics—Lamia Bekkour, Xisong Jin, Fanou Rasmouki and Lehnert—started analysing credit default swaps, which is something like an insurance policy on bonds, and price changes when various euro countries' bonds have come up for auction. *"I think we got something really interesting and novel here,"* Wolff says.

Citing data through January 2012, the paper suggests that contrary to popular thinking, *"Greece is not systematically relevant"* and the findings could suggest that *"too much attention was put"* into solving the Greek debt crisis by European leaders.

Wolff says another *"surprise"* is that *"France is less risky in our measurements than one might intuitively gather."* In fact, French debt has been one of the four lowest risk contributors, depending on the time period examined.

Less astonishingly, Ireland, Spain and Portugal contribute the most risk to the euro area and *"Italy also shows up convincingly"* in the tables, he reports.

The least risky countries overall are Austria, the Netherlands and Germany. Wolff explains that Luxembourg is not part of the study because there are no credit default swaps for the Grand Duchy's debt.

"GREECE IS NOT SYSTEMATICALLY RELEVANT"

CHRISTIAN WOLFF

Fund investors and risk

Lehnert is presenting research he and LSF colleague Fabian Irek conducted on the impact that investor *"moodiness"* has on market prices. Until a few years ago, most investigations into market sentiment were based on surveys sent to investors, which tended to have some bias built-in to the results.

Lehnert and Irek focused specifically on US equity fund flows, as very detailed data for the past 23 years is available there. That means the LSF researchers could look at what investors are actually doing, not only what they say about how they feel about the market.

Under traditional financial theory, *"if I invest in a stock that's more risky, I'm expecting a higher return,"* Lehnert explains. Bank depositors will accept low interest rates, for example, *"but if I invest in emerging market stocks, which are highly risky, then of course I want a higher return."* But what if there is a decou-

pling of the risk-return relationship in times of crisis?

Initial findings suggest that the traditional correlation has indeed broken down during *"high sentiment"* periods, when investors' moodiness is higher. When panic sets in, risk is no longer reflected in equity prices, in other words.

Fund firms in Luxembourg take note: *"In normal times it makes sense to invest in risky assets. In times when market prices are affected by sentiment, then it doesn't make sense to invest in risky funds. What we show is that fund investors seem to be aware of that."*

The pair is now testing for the *"smart money effect"*, which posits that *"those funds that experience outflows, where private investors are withdrawing funds out of mutual funds, experience negative returns in a subsequent period"* while funds that experience positive flows *"have a positive return in the subsequent period."*

NIKOLAOS PAPANIKOLAOU
Small banks take big risks



Too small to survive banks

The financial crisis was likewise a topic for Papanikolaou and Theoharry Grammatikos, also of the LSF, who looked at the US banking sector. Since 2007 nearly 500 American banks have failed--at the cost of more than \$100 billion in government guarantees--and in 2008 Washington created the so-called "Tarp" bailout fund for bigger institutions--budgeted at \$700 billion, although less than half was actually used.

Papanikolaou and Grammatikos looked at why regulators chose to bail out some banks and why some were left to go bust. Using "some rather sophisticated econometric modeling techniques", the LSF academics found "that the optimal bailout point for authorities is

the one that only considers large sized banks" and regulators "disregard small banking institutions as they are of no importance for the system."

"However we also supply support to the view that small banks, which are not saved by the authorities, and are not considered by the authorities as being systemically important and hence are not protected by bailout policies, take higher risk," explains Papanikolaou.

"This happens because small, and also some medium sized banking firms, are aware, either implicitly or explicitly, that in case of a banking crisis or financial distress, they will probably not survive. So they follow a rather moral hazard strategy," he observes.

The findings could potentially help shape "the new global regulatory framework for the banking industry, which is widely known as the Basel III agreement" currently being developed.

Remarkably, given the sums involved, Papanikolaou says the questions in their paper "have never been addressed" by journals nor by the popular financial media. "It seems like both the academic literature and the press is almost exclusively focused on the 'too big to fail' banking institutions. I'm sure that you have heard of this term before, but I'm sure that you have never heard of the term 'too small to survive banks' before."

You heard it first in Luxembourg. //